Insights
Model Portfolios

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Model Matters

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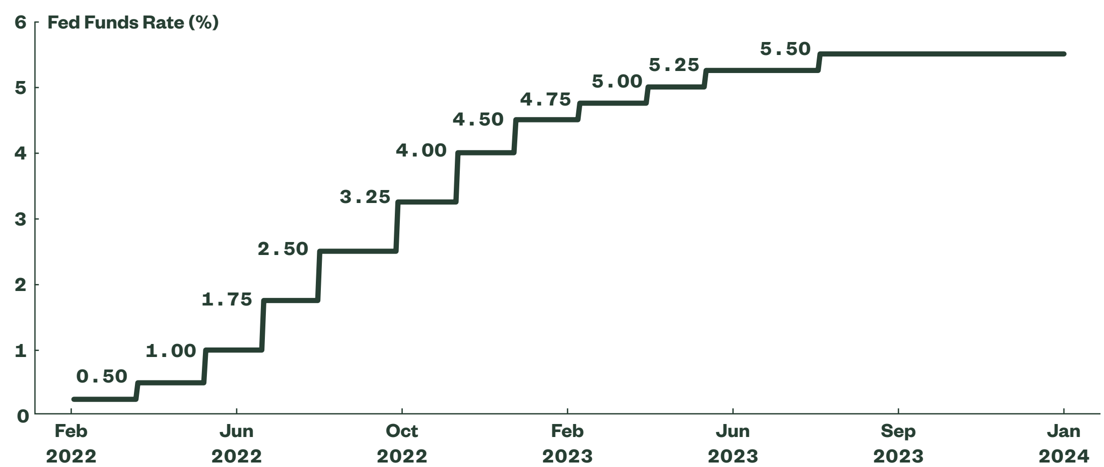
Exploring the current market landscape through the lens of State Street Global Advisors' investment process

What Are We Thinking?

2023 seemed to be the year that everyone called for recession. But those who accepted that narrative found themselves playing catch-up in a market that provided rewards, albeit in a narrow, segmented market that included growth, mega-cap, AI, or GAMMA (Google, Amazon, Meta, Microsoft and Apple) companies.

For the duration of the year, the State Street Active Asset Allocation ETF Portfolios were significantly overweight equities, acknowledging the durability of markets buoyed by a strong labor market and a free-spending consumer. We believe that the tide may change in 2024. Interest rates peaked in July, which marked not only the end of the Federal Reserve's (Fed) valiant inflation-fighting campaign, but also the beginning of a new campaign that the Investment Solutions Group (ISG) believes will be characterized by an absence of strong growth. ISG feels the hiking interval that included 11 hikes and over 525 bps of rate increases[1] will start to wear on consumers and businesses, as lagging interest rate increases finally take their toll. The call is not for recession; instead, it's for a soft landing based on compelling evidence of resilience and strength in both consumers and businesses compared to other post-peak rate periods. However, a recession is not impossible. Despite its best intentions, the Fed could raise interest rates one time too many if inflation growth does not meet targets or if geopolitical tensions tip the scale the wrong way. Quantitatively, ISG believes that there is less than a 30% chance of recession and that it's more probable for weakness to prevail.

Figure 1
Fed Funds Target Rate: A Fast Rate-hiking Campaign Over a Short-term Period



Source: FactSet, as of January 22, 2024.

The Long-term View

“What Are We Thinking?” represents ISG’s views on markets with a three-month lens or less. But what about ISG’s long-term view? Every December, ISG updates its 10-year market expectations to inform the allocations in our Strategic Asset Allocation ETF Portfolios. The final model allocations are determined by a combination of inputs, including expectations for long-term returns, risks and correlations, portfolio constraints, portfolio objectives, investment vehicle considerations, portfolio optimizations, and qualitative considerations. This past December, equity expectations were modestly lower due a continued market run-up and strong valuations. On the fixed income side, long-term expectations improved since last year. Higher initial yields or rates point to better immediate income and higher potential for longer-term price increases.

Constructing a Long-term Expectation

While competitors may accept the market’s composition to guide strategic allocations, ISG forecasts asset class returns to inform portfolio composition through a building-block based approach. Asset class expectations, in their simplest form, are a combination of returns from two sources: price and income. A building-block approach is an even more detailed analysis of price and income that permits a finer quantification of these basic inputs.

For example, the equity expectation process begins with an estimation of large-cap stocks. The following components of returns are considered before arriving at the final long-term expectation:

- **P/E (Price-to-Earnings) Reversion Effect** estimates the degree to which P/Es revert to the long-term mean.
- **Long-term Inflation** is estimated using a combination of consensus estimates and qualitative adjustments.
- **Long-term Real Earnings Growth** is assumed to be tightly coupled with economic growth, so by estimating changes to productivity and demographics, the team can determine sensible estimates.
- **Current Dividend Yield** is the most recognizable and observable component of return — the current market yield.
- **Buyback Yield** is another component of return as a result of companies buying back shares. While this form of yield has not always been material, it has had greater influence in the past decade. ISG estimates buyback yield using a combination of history and qualitative judgement.
- **Style Premia** might also be added to the above components to provide forecasts for different asset classes like small and mid caps. ISG uses long-term averages for these estimates.

Figure 2
10-year US Equity Return Expectations

Summary Forecasts for US Equities	(%)
P/E Reversion Effect	-0.01
Long-term Inflation Estimate	2.05
Long-term Earnings Growth	1.50
Current Dividend Yield	1.62
Buyback Yield	0.64
Large Caps	5.81
Mid Caps (Premium Added)	6.06
Small Caps (Premium Added)	6.18

Source: State Street Global Advisors Investment Solutions Group, as of September 30, 2023.

Fixed income return expectations also examine price and income return patterns. However, an estimation for default rates is added to arrive at a more precise estimate. The following components are factored into fixed income return estimates:

- **Income Return** is the weighted average of the current and expected interest rate.
- **Price Return** is estimated from the product of the current index duration and the expected change in yield over the time horizon.
- **Default Rate** is used to determine the index's diminished return from company defaults.

Keeping the Short and Long Term in View

ISG estimates both short- and long-term returns when managing the State Street ETF Model Portfolios . The overall process begins with allocations influenced by the long-term view which incorporates the component estimates highlighted above. Once the allocations of the strategic process are established, the active portfolios use these strategic portfolios as a starting point to further refine shorter-term allocations that are influenced by near-term expectation models.

Endnote

1 FactSet, as of December 31, 2023.

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Diversification does not ensure a profit or guarantee against loss.

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